

ANALYSIS OF ORIGINAL BILL

Author: Bowen Analyst: Colin Stevens Bill Number: AB 2165
Related Bills: _____ Telephone: 845-3036 Introduced Date: 2/19/98

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Business Expense Deduction/Environmental Remediation Expenses Conformity

SUMMARY

Under the Personal Income Tax Law (PITL), and the Bank and Corporation Tax Law (B&CTL), this bill would conform to Internal Revenue Code (IRC) Section 198 relating to "brownfields" and would allow taxpayers to deduct the cost of any qualified environmental remediation expenditure.

EFFECTIVE DATE

This bill would become effective upon enactment and would apply to expenses paid or incurred on the first day of the first calendar quarter commencing more than 90 days after enactment. However, it applies only to taxable or income years beginning on or after January 1, 1999.

SPECIFIC FINDINGS

The Taxpayer Relief Act of 1997 (P.L. 105-34) (TRA) enacted new federal law that, among other things, allows taxpayers to elect to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred. The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site and must occur on or before December 31, 2000. In general, any expenditure for the acquisition of depreciable property used in connection with the abatement or control of hazardous substances at a qualified contaminated site does not constitute a qualified environmental remediation expenditure. However, depreciation deductions allowable for property that would otherwise be allocated to the site are treated as qualified environmental remediation expenditures.

A "qualified contaminated site" is generally any property that:

- (1) is held for use in a trade or business, for the production of income, or as inventory;
- (2) is certified by the appropriate state environmental agency as located within

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE

____ GOVERNOR'S APPOINTMENT

Board Position:

____ S ____ O
____ SA ____ OUA
____ N ____ NP
____ NA ____ NAR
____ X ____ PENDING

Agency Secretary Position:

____ S ____ O
____ SA ____ OUA
____ N ____ NP
____ NA ____ NAR
DEFER TO _____

GOVERNOR'S OFFICE USE

Position Approved ____
Position Disapproved ____
Position Noted ____

Department Director Date
Gerald H. Goldberg 3/13/98

Agency Secretary Date

By: _____ Date

- a targeted area; and
- (3) contains (or potentially contains) a hazardous substance (so-called "brownfields").

Targeted areas mean:

- (1) empowerment zones and enterprise communities as designated under present law and under the TRA;
- (2) sites announced before February 1997, as being subject to one of the 76 Environmental Protection Agency (EPA) "brownfields" pilots;
- (3) any population census tract with a poverty rate of 20% or more; or
- (4) certain industrial and commercial areas that are adjacent to census tracts described in (3) above. Both urban and rural sites qualify. However, sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) cannot be targeted areas.

With respect to certification of targeted areas, **the TRA provides** that the chief executive officer of a state may, in consultation with the Administrator of the EPA, designate an appropriate state environmental agency for certifications in that state. If no state environmental agency is designated within 60 days of the date of enactment (August 5, 1997), the Administrator of the EPA shall designate an appropriate state environmental agency for that state. The California Environmental Protection Agency (Cal EPA) has been designated as the administrator for California. However, according to staff from the Department of Toxic Substances Control, that department will administer most aspects of the program for Cal EPA.

Hazardous substances generally are defined by reference to certain sections of CERCLA, subject to additional limitations applicable to asbestos and similar substances within buildings, certain naturally occurring substances such as radon, and certain other substances released into drinking water supplies due to deterioration through ordinary use.

The TRA provides that in the case of property for which a qualified environmental remediation expenditure otherwise would have been capitalized, any deduction allowed under the TRA is treated as a depreciation deduction and the property is treated as subject to section 1245 recapture upon disposition. Thus, deductions for qualified environmental remediation expenditures would be subject to recapture as ordinary income upon sale or other disposition of the property.

California law generally conforms to the federal trade or business expense deduction provisions. In addition, California provides certain special business expense deductions as provided in the IRC as it read January 1, 1997. For instance, a business located in an economic development area may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the economic development area.

California law has not conformed to recent changes to the federal "brownfields" business expense deduction.

Under the PITL and B&CTL, this bill would conform state law to IRC 198 for qualified expenditures made in taxable or income years beginning on or after

January 1, 1999, and would allow any qualified environmental remediation expenditure paid by the taxpayer to be deducted for the taxable year in which the expenditure is paid or incurred.

Policy Considerations

This bill would not limit the Section 198 treatment of qualified remediation expenditures to properties located in California. Therefore, taxpayers may be able to claim the deduction based on remediation of sites located outside California. However, according to staff at the author's office, the bill is intended to apply only to qualified remediation undertaken in California. Amendments 2 and 5 are provided at the author's request to clarify that the deduction would be allowed only for qualified remediation undertaken in California.

Since this bill would conform to IRC 198, which applies only to expenditures incurred on or before December 31, 2000, the provisions of this bill would be available to taxpayers only for 1999 and 2000.

This bill would conform state law to current federal law, thereby reducing the complexity of California tax return preparation for taxpayers who elect to expense qualified remediation costs under federal law and who make the same election on their California income tax return.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

Technical Consideration

This bill seeks to conform state law to the recently-enacted IRC Section 198. However, since current state tax law conforms to the IRC as it read January 1, 1997, and IRC Section 198 was not enacted until August 5, 1997, the reference in the bill would be technically incorrect. Amendments 1 and 4 would conform to IRC Section 198 as added by the TRA.

The B&CTL provision incorrectly would allow the brownfields deduction for taxable years. However, income years are used to describe B&CTL taxpayers' accounting periods. Amendment 3 would clarify that the deduction would be allowable for income years under the B&CTL.

The operative date in this bill is unclear. While the bill applies to taxable/income years beginning on or after January 1, 1999, it also contains language that makes it operative on the first calendar quarter commencing more than 90 days after the effective date of the bill. That operative language is generally used for sales and use taxes.

FISCAL IMPACT

Departmental Costs

This bill is not expected to significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses from this provision are estimated to be:

Estimated Revenue Impact Effective After January 1, 1999 and Before January 1, 2001 Enactment Assumed After June 30, 1998 (in millions)			
	1999-0	2000-1	2001-2
Personal Income Tax	(\$1)	Minor loss	Negligible gain
Bank & Corporation Tax	(\$5)	(\$2)	Negligible gain
Total	(\$6)	(\$2)	Negligible gain

Minor Loss = Less Than \$500,000
Negligible Gain = Less Than \$250,000

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue effect for this provision would depend on accelerated deductions taken by taxpayers electing to treat certain environmental remediation expenditures that would otherwise be chargeable to capital account as deductible in the year paid or incurred.

The impact above was based on federal estimates for the Taxpayer Relief Act of 1997 (P.L. 105-34). Revenue losses drop off in later years because of recapture upon disposition of "brownfields" that have been remediated.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2165
As Introduced February 19, 1998

AMENDMENT 1

On page 2, line 4, after "Internal Revenue Code," insert:
as added by Section 941 of the Taxpayer Relief Act of 1997

AMENDMENT 2

On page 2, line 6, after "expenditure", insert:
for property located in this state

AMENDMENT 3

On page 2, line 13, strike "taxable" and insert:
income

AMENDMENT 4

On page 2, line 14, after "Internal Revenue Code," insert:
as added by Section 941 of the Taxpayer Relief Act of 1997

AMENDMENT 5

On page 2, line 16, after "expenditure", insert:
for property located in this state